

Commonwealth of Kentucky

Presentation of Recommendations

December 6, 2007

GRS

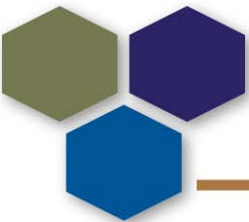
Gabriel Roeder Smith & Company
Consultants & Actuaries
www.gabrielroeder.com

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Discussion Topics

- ◆ Recommendations on Financing
- ◆ Recommendations on Pension Benefits
- ◆ Recommendations on Health Care Benefits
- ◆ Recommendations on Plan Governance



Recommendations on Financing



Exploration of Investment Returns

- ◆ Conduct an operational and a governance review of the investments
 - ▶ Use the Wilshire material as a model for areas of review
 - ▶ Review operation for implementation of best practices
 - ▶ An independent review of investments every three years by each system



Phase In To Full ARC Payment

- ◆ Phase in to the full ARC over a 10 year period
 - ▶ Start with the 2008 contributions at the greater of the normal cost or the current year anticipated total contribution
 - ▶ Increase $1/10^{\text{th}}$ of the way in each subsequent year



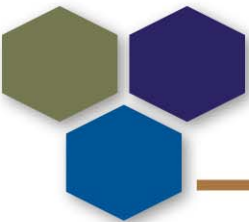
Prefund Part Of The Phase-in

- ◆ Using bonds, prefund part of the phase in
 - ▶ Always place the proceeds first into the insurance funds, so their ARC has a higher probability of being met
 - ▶ Issue bonds only after a reexamination of current market conditions and risks



Other Financing Recommendations

- ◆ Define the “full funding” standard to be used by KRS in calculating employer contribution rates for member agencies
- ◆ Halt borrowing from the pension funds to pay for the cost of health insurance



Recommendations on Pension Benefits



Recommendations To Or By Work Group 2

- ◆ A number of recommendations for DB plan changes have been received by or on behalf of Work Group 2
- ◆ Recommendations received from both interested individuals and interested groups



Recommendations To Or By Work Group 2

- ◆ In our presentation, GRS offered our opinions why or why not many of the suggestions would work to reduce current or long term DB costs for Kentucky
- ◆ After hearing our presentation and discussing it, one recommendation was approved related to benefit design
 - ▶ Change the KRS COLAs to an employee-prefunded 1.5% COLA like the KTRS COLA



Impact of Prefunding the KRS COLAs

- ◆ Unfortunately, based on previous calculations by CavMac, such a proposal would be very expensive for members
- ◆ The high cost for prefunding the current COLA is greatly affected by the large liability associated with existing retirees
- ◆ The table on the next slide provides the % of pay increase for employer-prefunding of the current COLA



2007 Employer DB Costs For Prefunding KRS COLAs

System (1)	Increase in Normal Cost (2)	Increase in UAAL Rate (3)	Increase in Total Rate (4)
KERS Non-Hazardous	2.53%	9.50%	12.03%
KERS Hazardous	4.57%	7.09%	11.66%
SPRS	6.27%	21.51%	27.78%
CERS Non-Hazardous	2.68%	5.48%	8.16%
CERS Hazardous	5.31%	9.58%	14.89%



2007 Impact of Prefunding KRS DB COLAs

- ◆ The increases for a 1.5% COLA instead of the current COLA would be a little less than $\frac{1}{2}$ of these increases since the COLAs are compounding
 - ▶ While not calculated at this time, these costs might be between $\frac{1}{3}$ and $\frac{1}{2}$ of those costs
- ◆ Employee funding would be greater than employer funding because of the “leakage” of refunded contributions for terminating employees



GRS's DB Recommendations Do Not Include A COLA

- ◆ Because of the size of these immediate contribution increases, GRS has not included an automatic COLA feature in the remainder of this portion of the presentation
 - ▶ Even though moving from a variable automatic COLA with a 5% annual maximum to a fixed 1.5% COLA does reduce the rate of growth in the current provision's impact on KRS funding levels



Available Options For Reducing Long Term Costs of Kentucky DB Plans

- ◆ Inviolable Contract issue significantly limits the Commonwealth's ability to reduce DB costs for existing plan members, both active and retired
- ◆ Can create new tier with less expensive benefits, eligibility, and features within each plan to cover future New Entrants
 - ▶ But New Entrant tier only reduces growth of costs, not immediate costs



Available Options For Reducing Long Term Costs of Kentucky DB Plans

- ◆ KERS, CERS, and SPRS COLA feature needs to be changed
 - ▶ For COLA not to be granted in any year, General Assembly (GA) must pass a bill specifically prohibiting the new year's COLA from being implemented
 - ▶ Very hard politically for GA to take such a negative action, even if not taking it exacerbates a worsening funded position in the affected plans



GRS Recommendations For Reducing Long Term Costs of Kentucky DB Plans

- ◆ Completely eliminate COLA provision from current KERS, CERS, & SPRS provisions
 - ▶ Impacts both current active members and current retired members
 - ▶ Future increases would need positive GA action to pass ad hoc COLAs, & each one must be funded
 - ▶ By itself, does not reduce current DB contribution requirements but reduces how those costs will increase in the future



GRS Recommendations For Reducing Long Term Costs of Kentucky DB Plans

- ◆ Create a lower-cost benefit tier for future New Entrants to KERS, CERS, and SPRS
 - ▶ No automatic COLA
 - ▶ Higher retirement eligibility
 - ▶ Lower benefit multiplier
 - ▶ No sick leave credit provisions
 - ▶ No eligibility credit for purchased service
 - ▶ Less liberal return-to-work provisions



Goal Of Recommended GRS DB Changes

- ◆ New Entrant tier will reduce long term costs
- ◆ Eliminating current non-guaranteed but non-pre-funded COLAs will reduce long term costs and liabilities
 - ▶ Future GAs would decide when COLAs should increase costs & liabilities by passing funded ad hoc increases
 - ▶ Ad hoc increases would require funding over average life expectancy for eligible group



Specific GRS DB Recommendations

- ◆ Eliminate current COLA provision in KERS, CERS, & SPRS
- ◆ All future COLAs would be periodic ad hoc COLAs passed with funding by GA
- ◆ Create a new tier of benefits in KERS, CERS, & SPRS that would apply to all future New Entrants



GRS Recommended New DB Tier

Provision (1)	KERS & CERS Non-Hazardous (2)	Hazardous & SPRS (3)
Benefit Multiplier	1.75%	2.00%
Unreduced Retirement	65 & 5 or Rule of 85 w/ age 55 minimum	25 & out w/ Age 50 minimum
Reduced Retirement	55 & 5	50 & 15 (Same as current New Entrants)
Reduction for reduced Retirement	6.0% per year early	6.0% per year early



GRS Recommended New DB Tier

Provision (1)	KERS & CERS Non-Hazardous (2)	Hazardous & SPRS (3)
Vesting	5 years of service (Same as current New Entrants)	5 years of service (Same as current New Entrants)
Exclusions from eligibility service	Excludes all purchased service and unused sick leave (Same as current New Entrants)	Excludes all purchased service and unused sick leave (Same as current New Entrants)
New Entrant Employees to be covered	Same as current New Entrants plus future New Entrants who do not qualify for new SPRS or Hazardous	Future New Entrants who actually perform duties as police officers or fire fighters



GRS Recommended New DB Tier

Provision (1)	KERS & CERS Non-Hazardous (2)	Hazardous & SPRS (3)
Components of Compensation	Excludes Unused Sick Leave payments and any lump sum payments or other terminal pay	Excludes Unused Sick Leave payments and any lump sum payments or other terminal pay
Final Average Pay (FAE)	5-year average (Same as current New Entrants)	5-year average
Method for FAE Calculation	Sum of compensation for highest 5 consecutive Plan (or Calendar) Years out of last 10 Plan (or Calendar) Years worked, divided by 5 for annual FAE	Sum of compensation for highest 5 consecutive Plan (or Calendar) Years out of last 10 Plan (or Calendar) Years worked, divided by 5 for annual FAE
COLAs	None promised. All would be funded ad hocs	None promised. All would be funded ad hocs



GRS Recommended New DB Tier

Provision (1)	KERS & CERS Non-Hazardous (2)	Hazardous & SPRS (3)
Employee Contribution Rate	6% of pay + 1% for retiree med	9% of pay + 1% for retiree med
Interest on Employee Contribution Account	2.5%, set by Board (but none on 1% retiree med contribution)	2.5%, set by Board (but none on 1% retiree med contribution)
Pre-retirement death benefit provisions	Same eligibility & amount as what current new hires have	Same eligibility & amount as what current new hires have
Post-retirement lump sum death benefit	Same as what current new hires have	Same as what current new hires have
Disability benefit provisions	Same eligibility & amount as what current new hires have	Same eligibility & amount as what current new hires have



GRS Recommended New DB Tier

Provision (1)	KERS & CERS Non-Hazardous (2)	Hazardous & SPRS (3)
Unused Sick Leave	Excluded from all calculations and eligibility features	Excluded from all calculations and eligibility features
Service Purchase	Full actuarial cost (including assumed future pay increases, earliest unreduced retirement date, and any automatic COLA); excluded from all eligibility requirements	Full actuarial cost (including assumed future pay increases, earliest unreduced retirement date, and any automatic COLA); excluded from all eligibility requirements
Eligibility for Retiree Medical	Access-only if reduced retirement. Any applicable subsidy if unreduced retirement. None if a vested terminated participant beginning benefit at eligible retirement age.	Access-only if reduced retirement. Any applicable subsidy if unreduced retirement. None if a vested terminated participant beginning benefit at eligible retirement age.



GRS Recommended New DB Tier

Provision (1)	KERS & CERS Non-Hazardous (2)	Hazardous & SPRS (3)
Return To Work After Retirement (RTW)	After 12 months regardless of participating KRS,CERS, SPRS or KTRS employer or position, and regardless of whether full-time or part-time. No additional benefit earned. Employer contributes its applicable rates on RTW retirees' pay.	After 12 months regardless of participating KRS,CERS, SPRS or KTRS employer or position, and regardless of whether full-time or part-time. No additional benefit earned. Employer contributes its applicable rates on RTW retirees' pay.
Rehire After Prior Termination	Enters New Entrant tier	Enters New Entrant tier



A Combined DB/DC Alternative for New Entrant Tier

- ◆ 2007 passed and at least one individual recommendation was for a combined DB/DC program
- ◆ In GRS's opinion, making such a program optional for current members is not workable in Kentucky because of Inviolable Contract issue
 - ▶ GRS discussed reasons with Work Group 2



A Combined DB/DC Alternative for New Entrant Tier

- ◆ Would have a reduced DB multiplier and a reduced employee DB contribution rate in combination with a mandatory DC plan
- ◆ Could use Kentucky's "grandfathered" 401(k) plan as the DC vehicle
- ◆ But DC plans are not frequently used for fire & police



A Combined DB/DC Alternative for Non-Hazardous New Entrant Tier

- ◆ GRS recommends one of two scaled-back DB multipliers if this option is desired for other than KERS Hazardous, CERS Hazardous, & SPRS New Entrant tiers
 - ▶ 1.25% multiplier with 2.5% employee contribution rate for the DB plan,
 - or
 - ▶ 1.00% multiplier with no employee contributions to the DB plan
- ◆ All other DB features would remain the same as previously recommended
 - ▶ Including the 1% employee contribution for retiree medical



A Combined DB/DC Alternative for Non-Hazardous New Entrant Tier

- ◆ New Tier DC plan could have the basic features of the DC plan envisioned in the Senate-passed version of HB 418 with respect to such features as limited access to accounts and life cycle funds
- ◆ Mandatory participation of non-hazardous New Entrants would be required
 - ▶ Mandatory minimum employee DC contribution rate would be 6% less any DB plan required contribution



A Combined DB/DC Alternative for Non-Hazardous New Entrant Tier

- ◆ Employer could have a mandatory minimum contribution to DC plan equal to 3% of pay
- ◆ Alternatively, employer could make matching contributions up to 3% of pay
- ◆ New DC plan should have modern DC features such as on-line and voice-response access, daily valuation, changes to investment options, etc.



A Combined DB/DC Alternative for Non-Hazardous New Entrant Tier

- ◆ For the new DB/DC combination plan not to harm the existing DB plans, it should not be offered as a participation option to current plan participants
 - ▶ The “high-DB-cost” employees wouldn’t switch, but the “low-DB-cost” ones would
- ◆ If variable employee contributions are included, the existing grandfathered 401(k) plan should be used for efficient tax sheltering



A Combined DB/DC Alternative for Non-Hazardous New Entrant Tier

- ◆ Such a combination plan would require projections and analysis by CavMac as to whether it would have more, less, or the same financial impact as the GRS recommended DB plan



Other Items Discussed with WG II

- ◆ Create an optional new tier for current plan participants that would have the same basic design as the GRS recommended New Entrant tier, but with a scaled-back prefunded automatic COLA
- ◆ Make new tier be a pure DC plan
 - ▶ Considered by GRS but rejected as not workable for Kentucky because of Inviolable Contract issue
- ◆ Create a comparable New Entrant tier in KTRS



Summary of Pension Benefit Issues

- ◆ Not all of current DB problems are due to 2000 – 2003 investment markets
- ◆ Inviolable Contract issue significantly limits cost-saving alternatives for current members
- ◆ Non-funded, non-guaranteed COLA in KERS, CERS, & SPRS is only real source of long-term cost reductions for current members



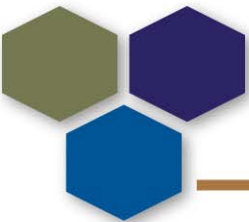
Summary of Pension Benefit Issues

- ◆ Can create a lower-cost new tier for New Entrants to these plans
- ◆ Can consider a number of other options for new tiers



Next Steps on Pension Benefit Issues

- ◆ Finalize provisions of new tier
- ◆ Have Cavanaugh-Macdonald determine applicable normal costs as plan's long-term base-line cost & revised contribution rates



Recommendations on Health Care Benefits



Recommendations on Plan Design Options

- ◆ Leverage current PPO platform into a Hi, Medium, Low option plan
 - ▶ Greater differential between the Enhanced and Premier plans
 - ▶ Adjust contribution for greater steerage
- ◆ Collapse Enhanced & Premier plan into one plan.
 - ▶ Position at 1.01 to 1.04 in relation to 1994 plan
 - Bring Essential plan up to .85 to .90
 - Adjust contribution for greater steerage
- ◆ Implement a “spousal surcharge”
 - ▶ Addresses spouses that are eligible for benefits at their employer



Recommendations on Plan Design Options

- ◆ Refine Employer and Employee cost share calibration
- ◆ Further evaluate the cross-reference benefit employee/employer cost sharing
- ◆ Freeze dependent subsidy amount at 2008 levels
- ◆ Back into a plan design based on the inflation adjusted 1994 premiums.
 - ▶ Leverage the delta between the '94 inflation adjusted premiums and current premiums



Recommendations on Plan Design Options

- ◆ Require participation of employees with “high cost” conditions in “care/disease management” programs
- ◆ Explore the feasibility of separating CERS local government retirees from the Kentucky Employee Health Plan and providing them appropriate coverage
- ◆ As state employees, part-time school board workers now in CERS should be transferred to KERS and retain retiree health insurance coverage through the Kentucky Employees Health Plan



Recommendations on Strategic Planning

- Establish three year planning horizon for benefit plan design
 - ▶ Make plan changes that will carry forward for most/all of that period

- Create “decision filters” for planning purposes; way points of strategic planning
 - ▶ Objective, measureable, repeatable statements
 - “KY per capita costs at X% of national average”
 - “KY trend factor at X% of national average”
 - ▶ Helps to minimize plan “tweaking”
 - ▶ Provides consistent basis for change



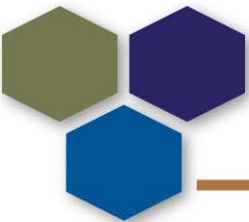
Recommendations on Plan Management

- ◆ Audit claim administrator every 12 to months
- ◆ Audit PBM every 12 to 24 months
 - ▶ Not the same as a claim audit, this has a clinical component to it
- ◆ Conduct a dependent audit every 3 to 5 years
 - ▶ Identifies ineligible dependents currently on the plans
- ◆ Explore the possibility of availability of a statewide provider network



Recommendations on Legislative Issues

- ◆ Clarify the “Kentucky Kare Standard” language in KRS 18A



Recommendations on Plan Governance



Recommendations on Plan Governance

- ◆ Create a Consensus Pension Benefit Review Group comprised of persons with specific pension and investment management experience to review and sign-off on any benefit enhancement proposal before it can be considered by the General Assembly
- ◆ Require an actuarial analysis before any proposed pension benefit change may be considered by the Consensus Pension Benefit Review Group (if adopted) or a Legislative Committee or Body



Recommendations on Plan Governance

- Given the purported breadth of Kentucky's "inviolable contract", require any proposed pension benefit enhancement to be introduced and considered in not less than two sessions of the Kentucky General Assembly before it can be enacted and become law
- Require that at least one and preferably two appointed members of the KRS and KTRS Boards have professional experience in the area of private investment, funds management, or pension funds



Recommendations on Plan Governance

- ◆ Add a local government administrative representative to the KRS Board
- ◆ Require investment and fiduciary training for all Board members of all pension systems



Contact Information

Leslie Thompson, FSA

Consultant to WG I

303/846-3038

leslie.thompson@gabrielroeder.com

Mike Carter, FSA

Consultant to WG II

469/524-1801

mike.carter@gabrielroeder.com

Jim Schaefer

Consultant to WG III

469-524-1808

jim.schaefer@gabrielroeder.com